Market Leader

ADR ISSUANCE

The post-SOX challenge for ADRs

The appetite for foreign listings in the United States is still rising. In October 2005, Standard & Poor's (S&P's) investment policy committee raised its recommended international stock allocation to 20% from 15%. Back in August the same year JP Morgan Private Bank boosted its suggested holdings of foreign stocks to around 33% from 20%. With the continued growth of investment and trading activity in non-US equities, companies need to think beyond the direct costs of complying with the Sarbanes-Oxley Act (SOX) of 2002 when making listing or de-listing decisions in the US market. They should be evaluating the overall benefits of having a presence in the US markets, which include the potential for higher valuations as a result of being a US exchange-listed issuer, as well as the positive investor perception of compliance with SOX writes Patrick Colle, global head of ADRs at JPMorgan.

THE US MARKET continues to provide abundant depth and liquidity for foreign issuers. As of the third quarter (Q3) of 2005, US investment in non-US equities was worth approximately $2.82trn, representing approximately 15.8% investment in non-US issuers *(please refer to Figure 1)* and demonstrates an overall trend toward higher investment in foreign securities. Similarly, trading volume on US exchanges for ADRs is at record levels, with trading volumes of 41.43bn shares for 2005 exceeding last year's volume of 41.3bn shares traded.

While direct costs of complying with SOX can be substantial, a presence in the US market can be critical to the global equity strategy of many non-US companies. For foreign companies that are already listed on a US stock exchange or are considering being listed, it is important that they work with partners that continually monitor market trends such as investment activities and trading volumes, as well as events that could have an impact on issuer clients and the depositary market. Leading depository banks are keeping a close watch on the impact of SOX on non-US companies that are either contemplating utilising the US markets or re-evaluating their commitment to them.

Although costs can vary from company to company, a recent study by law firm Foley and Lardner (quoted in the *Wall Street Journal*) calculated that the average audit bill for an S&P SmallCap 600 company (average revenue of $825m) was around $1m. Comparable costs for an S&P MidCap 400 (average revenue of $2,125m) were $2.2m. It is reasonable to expect, however, that compliance costs will diminish over time, since, for many companies, a large component of their SOX expenditure consists of one-time initial costs associated with documenting, assessing and upgrading their internal financial controls.

Although the costs of listing have stirred a healthy dialogue, the measurable impact in terms of new ADR issuers coming to market and US exchange de-listings is moderate to date. Issuers that have de-listed have significantly less activity in their ADR and local programmes compared to listed companies. Of course, it is important to bear in mind that the cost of compliance is just one of many reasons why a company may choose to de-list or not have a presence in the US markets. However, there has not been a significant upturn in de-listings in either 2004 or 2005. Some 13 de-listings took place in 2004 and 15 de-listings in 2005 – compared with 21 in 2001, 10 in 2002 and 15 in 2003 *(please refer to Figure 2)*. Likewise, de-listed issuers had 50% smaller market capitalisations relative to listed companies. It is notable, however, that there was a significant decrease in listings from 2000 to 2001 due in part to the end of the internet boom.

New listings, meanwhile, on the major US exchanges by foreign companies have remained strong over the half decade. Twenty-four new listings were recorded in 2004 and 20 listings in 2005, compared with 34 in 2001, 20 in 2002 and only 12 in 2003.

But the fact is that non-US issuers are increasingly raising capital elsewhere, through Global Depositary Receipt (GDR) listings for example, that are not in fact listed on US exchanges. In 2004 and 2005, for example, around 49% of capital raising, including initial public offerings (IPOs) as well as secondary offerings, was done in the form of GDRs, compared to 27% in the years 2001, 2002 and 2003. This trend is driven, in large part, by the recent surge of Asian companies looking to raise capital abroad. Of course, given the status of the US market as the largest and most liquid in the world, the longer-term impact of this trend is still being investigated. Additionally, there may be an incremental future impact because internal financial control report

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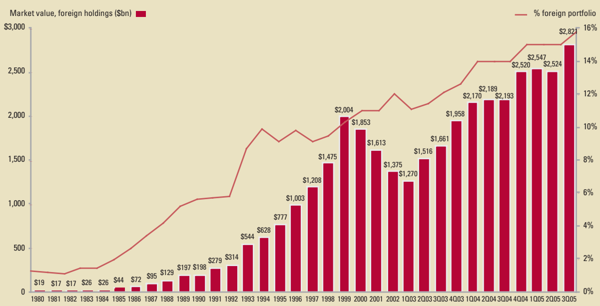
requirements under SOX will begin to apply to foreign issuers during 2006.

It is important to note that the US Securities ans Exchange Commission (SEC) recently proposed rule changes that would give foreign private issuers with limited investor interest in the US more flexibility to withdraw from the reporting requirements of the Securities Exchange Act of 1934. The rule changes are being commented on currently, and the market reaction remains to be seen.

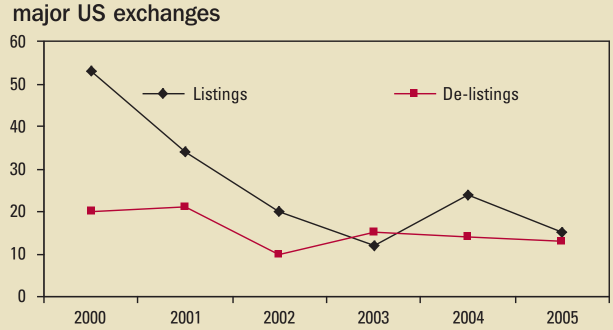
Figure 1: Capital flows: US investment in foreign equities (ADR and local shares)

Level of foreign investment – US investment in foreign equities (ADR and local shares), 1980 to 3Q 2005



Source: Federal Reserve, December 2005

Figure 2: Listings and de-listings by non-US issuers on major US exchanges



Source: JPMorgan, Bloomberg

Benefits of SOX compliance

There are significant benefits to complying with SOX, particularly as part of a US listing. In a recent survey of JP Morgan's issuer clients, over two-thirds said that maintaining their depositary program was a key component of enhancing their company's visibility, status and profile in the US and international markets, particularly as part of their strategy to globalise and generate more exposure. While almost all of our exchange-listed issuers are bearing higher costs as a result of SOX, around half have mentioned the positive perception associated with complying with more stringent regulations as part of the evolution to becoming a more global company. In fact, some GDR issuers are complying with more stringent regulations even though they are not required to do so.

A recent research study conducted at the University of Toronto and Ohio State University found a 14% valuation premium for cross-border programs – including exchange-listed and 144A programs – relative to non-cross border programs. This premium rose to 31% for exchange-listed companies, implying that investors do value US exchange-listings and the associated benefits, such as compliance, accounting standards and transparency of information. Studies have also concluded that a valuation premium exists for companies with good corporate governance practices. Additionally, there is evidence that higher credit ratings are given to well-governed companies, resulting in a lower cost of borrowing.

By reducing the risk of fraud and error and improving the quality of financial reporting, internal financial control requirements should ultimately result in improved operational efficiency. Similarly, compliance with provisions relating to disclosure controls and procedures should improve the accuracy and timeliness of information flow within the company and thereby increase efficiency. Additionally, inefficiencies and redundancies in the control process itself can be eliminated or reduced as a result of SOX compliance.

SOX likely to evolve.

Over time, experts believe that some further reform of SOX legislation is inevitable. Although companies will still be required to hold strong corporate governance standards, it is likely that regulators may, in future, reduce some of the direct cost on issuers. There are also concessions being made in the short-term. For example, the SEC has, on several occasions, delayed the implementation date for internal control reports. Currently, both US and foreign companies with a public float of less than $75m are not required to deliver internal control reports until their first annual report relating to a fiscal year ending on or after July 15, 2007. For larger US companies with a public float greater than $75m the internal control report requirement has already taken effect. Larger international issuers are not required to provide an internal control report until their first annual report relating to a fiscal year ending on or after July 15, 2006.